The Integrity of the Federal Reserve System

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THE Federal Reserve System has to do only with commercial banking.[1] Commercial banking has only to do with getting goods from producer to consumer. It operates on the assumption, ordinarily valid, that the sale of goods to the consumer produces funds to discharge whatever obligation has been created.

Investment banking, on the other hand, operates on the assumption that the capital loaned will be repaid out of the earnings its use permits in a specified number of years.

The essence of commercial banking is liquidity of the credit on which it functions. Its credit instruments must be of short maturity. The banks which invest in them undertake to pay on demand and they must have a constant inflow of funds or a means of quickly realizing on their credit instruments. It is necessary, therefore, that the goods against which such credit is granted should be always in process of sale.

Primarily and fundamentally the Reserve System was designed to provide for the credit instruments of commerce an instant sale. It was an attempt to organize not a new lot of banks, but a new banking machine supported by the resources of all its member banks.[2]

The Reserve System is then an organization of banks. The Reserve Banks draw their capital from banks. Banks give them all the business they have, except the government, which is their only other customer. The country has then a banking system composed of banks of various kinds, some chartered by the nation and some by the states, brought into a coöperating organization with the Federal Reserve Banks as the operating mechanism.

Over this operating mechanism of the coöperating organization of banks, the government exercises a general supervision. There are many people who thought the supervising authority should be different, but it isn't and it doesn't matter so long as it is competent and impartial.

The purpose of the Federal Reserve System was to provide for business just what has been provided. There was no purpose and no intention to establish government banks, and none was established. There was no purpose to help or favor operating banks because they needed neither help nor favors. There was a purpose and intention to put the operating, commercial banks in a better position to discharge their duties to business so that business might go on under any and all circumstances, if this could be achieved through an economic use of credit and competent credit machinery.

In relation to business, therefore, the Federal Reserve System is more than a banking system. It is a code for business behavior. It is more than a machine for expanding and contracting credit and currency. It is a means for the orderly and systematic functioning of business credit and,

[1] Permission to national banks to receive savings deposits and to exercise trust company powers does not affect the commercial nature of the Reserve System.

[2] Cf. Article by Professor Kemmerer in this volume.

through reapportionment of this credit, for the stabilization of business.

No comprehensive grasp of the System can be had if, among its attributes, is included that of a remedy for all business and financial ills. It is not. It can never save the day for the insolvent. It is man-made and man-operated. It has and must have limitations. It must not be concluded because it financed the War, that it can go on indefinitely producing rabbits of credit and currency out of an empty hat. It didn't do that even in war. It did give life and credit form to latent and dormant resources. It did make the unliquid at least temporarily liquid. But war demands such performances.

It might have been better if the Reserve System had been called on to do less, and more had been done through other means, the Treasury, for instance. It would have been as well for the country and better for the System. Had this course been followed the Reserve Banks would have avoided much harsh criticism for displaying their limitations, once war pressure was removed. Many suggestions for changing the System would never have been made. It would not have been expected to bring to realization so many fatuous dreams.

As an operating banking mechanism the System need not, however, be taken for what it is. Changes in the machinery may be made if the fundamental structure is not impaired. Any banking system is a thing of growth. If, in its final form, it shows that wisdom has been gained from experience and skill from practice, it begins to approximate general needs. The Reserve System is an evolution out of more than a century of hard and bitter, experience made harder and more bitter by experiments. Its mechanism is, therefore, of moment only as it permits the application of principles of demonstrated soundness. Its fundaments are vital, not only because they attest that old fallacies have been dismissed, but also because they have been proved under the test of practice.

Probably, in any organization applying rules of conduct, there is a degree of fluidity. Some measure of change is always possible even when not always desirable. But change for the sake of change is not progress or improvement. On the other hand, there is advantage in holding to fixed practice. It is not difficult to test the quality of any amendment proposed to the Federal Reserve Act. It is necessary only to get the fundamental purposes in mind. Anything out of accord with them may instantly be dismissed.

But a great banking system cannot grow and develop out of itself. Dealing with such an intangible as credit and so nebulous a quality as confidence, the attitude of the public must be reckoned with. So susceptible are banks generally to public opinion that the banker subconsciously, almost, considers that as a factor to be used in all his calculations. In any event the public is a factor in the future development of the Reserve System, as Paul M. Warburg points out elsewhere in this volume. If the public is dismissed because even a meager popular understanding of the intricacies of banking is beyond hope, the business man, from whom more may be expected, stands forth as a grim spectre.

The public, most assuredly, feels and does not analyze. The business man may be controlled by emotion rather than reason. The more certain the operations of the Reserve Banks, therefore, the better they will come to be understood. Eventually, although it may be only a hope, the public will

come to understand up to the point of having confidence.

Thus the public is an important factor in the development of the Federal Reserve System. There must be a growth without the banks as well as within them. The public mind must become attuned to them.

For the people the Reserve System is a precious thing. If it is to fulfill its work and its mission, they must view it with confidence. Its integrity is to be guarded with as much jealousy as the Constitution itself. The jealousy must be inculcated into the popular mind. The attainment of such a state is taken to be desirable. If it is, the prospect of its realization will be in constant jeopardy unless members of Congress can be induced to abandon the idea that the Reserve Act is subject to tinkering at the behest of any amateur banker.

KNOWLEDGE OF BANKING HISTORY HELPS TO PUBLIC UNDERSTANDING

Under the interpretation of the Federal Reserve System given above, its growth, improvement and development to the maximum of satisfaction and efficiency can be attained only if its fundamental purposes are understood. The forces without the System must contribute a share in this growth and development. These outside forces are the business men and the public generally.

There can be no adequate understanding or appreciation of the System unless there is a general familiarity with what preceded it. To this end the first section of this volume is given over to an historical review. The first article sketches the history of banking from 1791, when the First Bank of the United States was organized, down through the panic of 1907.[3]

Even cursory reading of these events will indicate the influence that old experiments and controversies exerted on the makers of the Reserve Act and the form and content of the law. In the struggle over note issues and redemption of bank notes will be found the causes for the demand that Federal Reserve notes be made "obligations of the United States." The workings of the national bank system will explain the development of reserve banking and the need for elasticity of both credit and currency, and so on.

In his article on "The Studies of the National Monetary Commission," Professor Weston illuminates the defects of the old banking system and shows how they were studied in relation to other systems and the probable needs of modern business for adequate banking service.

These needs found expression in the organization of the National Citizens' League for the Promotion of a Sound Banking System. The story of the organization of that movement is told by Mr. Harry A. Wheeler, who participated in it and who was also one of the organizers and the first President of the Chamber of Commerce of the United States.

Through the workings of the National Citizens' League, later supplemented by work of the Chamber of Commerce, the business men and the business organizations of the country were bound together. A community of thought on banking methods and services was thus brought about and translated into definite purpose.

To get this result—a first step toward legislation—demanded an elaborate educational campaign. Success in this venture was made more difficult because of the many schemes for monetary and banking reform conceived and promoted by modern John Laws. These enthusiasts, often seeing

[3] By B. H. Beckhart.

in banking the means of attaining universal happiness, found no other weapon than legislative compulsion or government operation of banks. Dismissing the exploded theories, it need only be said that the guaranty of bank deposits was the measure of reform being pressed with vigor at that time. It had many advocates in Congress. However, the educational campaign was persistently prosecuted and was successful to the extent necessary in bringing attention to sound economics in banking reform as against the pursuit of emotional rainbows.

In his article on "The Federal Reserve Act in Congress," Dr. H. Parker Willis gives an intimate recital of facts, many of which have not previously been published. As expert for the House Committee on Banking and Currency, Dr. Willis was familiar with every step in the development of the bill before it was in the Committee for discussion and subsequently. The political factor is here disclosed as it came forward to influence what was an economic product. The degree of interest of the Administration in the measure, the pressure placed on Congress and the suggestions from the Treasury and other departments are made clear.

In this phase of the development, distinction must be made between the administrative and the economic provisions. Control of the System was always a subject of contention. The decentralizing of credit and curbing of the supposed power of Wall Street and the "Money Trust" were always matters of political concern. The tendency toward government control of the operating banks themselves had to be guarded against. Over the economic provisions, there was less trouble. There was no disagreement of moment in this respect, but provisions strictly economic were often under pressure because of their relation to control in execution. Thus elasticity of note issue was confused with distribution of credit and would have been sacrificed or impaired if help for the farmer could have been secured thereby. One illustration of the confusion of economics and politics will suffice.

In an economic sense, rediscounting for profit was at that time unthinkable. The maturity of paper offered for rediscount at the proposed banks was of incidental importance. Commercial banks could not consider paper of anything but short maturity and it was equally clear that paper for rediscount would not be offered to the Reserve Bank by the discounting bank on the day of discount. But dozens of congressmen could not or would not understand that the farmer could have no direct dealing with the Reserve Bank. Hours of discussion in the Senate were given over to the maturity of agricultural paper. Senators who saw in the Reserve Act only a new way of settling the farmer's eternal credit problem, would have willingly destroyed the commercial character of the Reserve Banks on the chance of settling that question. The time agricultural paper for rediscount may run was increased to ninety days. This maturity would have been of no importance if the rediscount rates had ever been scientifically adjusted and is of little importance anyway. In August, 1921, the average maturity of rediscounted paper was 15.76 days. In September it was 17.22 days. In the Minneapolis Bank it was 42.06 days and in Boston 7.74 days. If maturities had not been mentioned in the Act, the result would probably have been the same.

The House bill as recommended by Chairman Glass' Committee was the real bill, as Dr. Willis points out.

Senator Owen had a different bill which he was induced, eventually, to abandon. There was also a bill fathered by the Treasury providing for a central government bank with the Treasury's gold as the capital. The fact that the gold belonged to the holders of the certificates issued against it, was thought to be insignificant. The advocates of this plan floundered about in it for some time until the President himself summarily suppressed it.

Dr. Willis shows clearly that the Glass bill was the Administration's bill. After all other proposals had been discussed, and mechanical changes were made—notably that providing for retirement of the bond-secured currency—the Act as passed was substantially the bill as it came from the House Committee.

The true purposes of the Federal Reserve Act will be found in the discussions and reports of the Banking and Currency Committee of the House, of which Carter Glass was chairman.

The beginning of the European War brought an almost instant business dislocation. Fear of panic was allayed by the summary closing of the stock exchanges. A currency famine was supposed to be imminent. The members of the Federal Reserve Board had been appointed about this time—August 9, 1914—but the time for opening the new Reserve Banks could not even be predicted.

In September the dormant National Currency Associations were awakened. These had been formed in many districts under the provisions of the Aldrich-Vreeland Act, passed after the panic of 1907. Emergency currency was issued to these Associations and met whatever stress there was, as told in Mr. Dodge's article.[4]

[4] "The Aldrich-Vreeland Emergency Currency."

Aside from the useful service of providing currency and thereby sustaining confidence, the operation of this law was effective to prove its incapacity to meet anything more than a passing strain. There were many men —bankers included—who thought that the demand for banking reform would be completely met by this law or any law which would permit the turning of bank assets into currency. It was a bit of good fortune that there was a demonstration to show that banking efficiency was a reserve and not a currency problem. It eliminated forever from consideration a half-hearted remedy.

EARLY PROBLEMS AND OPERATIONS OF THE FEDERAL RESERVE BOARD AND BANKS

The Federal Reserve Board and the Banks were organized without much difficulty. The Organization Committee toured the country to gather information and hear the arguments of the various civic and banking committees selected to advance the claims of the many cities which thought themselves entitled to selection as the homes of the Reserve Banks. There were many contenders for these honors and there was some bitterness. Fixing the boundary lines of the districts also caused contention. Political "pull" was exerted to influence the committee from without and political prejudice was working within. But these matters were of minor importance compared to the Organization Committee's interpretation of the provision as to the number of Banks. They decided that twelve should be immediately established, and not eight, to be increased to twelve later if experience showed twelve to be necessary.

Undoubtedly the Committee felt the pressure keenly. Southern cities were very ambitious and very influential. But, so far as politics was concerned,

its full force was not manifested until the matter of organizing the Reserve districts came before the Reserve Board for review in 1915.

The Federal Reserve Act (Section 2) says, "The determination of said organization committee shall not be subject to review except by the Federal Reserve Board when organized" and "the districts thus created may be adjusted and new districts may from time to time be created by the Federal Reserve Board, not to exceed twelve in all."

The Board seemed to think that provision mandatory. It was, therefore, in the performance of what they considered a duty that they turned to a study of district boundaries and the location of Reserve Banks. In several instances changes in boundaries were made, but when a discussion of the possible strengthening of the System by combining some of the districts (without closing any offices already established) was begun, political power began immediately to work.

The then Governor of the Board and the two ex-officio members combined to prevent any change of the kind under discussion. The ex-officio members —the Secretary of the Treasury and Comptroller of the Currency whose action as members of the Organization Committee was to be reviewed—and the Governor were a minority of the Reserve Board. But, over the signature of the Governor and without the authority or knowledge of the majority of the Board, they asked the President to transmit to the Attorney-General a request for an opinion defining the Reserve Board's powers of review.

The opinion was turned out over Saturday and Sunday, which may be considered unusual dispatch. When the Board met again it was faced with the Administrations' interpretation of the law and the interpretation was that the Board had no power to review the determination of the Organization Committee in a manner that might affect the existence of any of the twelve Reserve Banks already established.

The point to be made is that the integrity of the Reserve System is of indifferent consequence in the face of political exigency. Perhaps just such a thing will not happen again but this is the second instance in which appeal was made to the Attorney-General to give legal support to a plan politically desired.

The fear of future political assaults on the integrity of the Reserve System is so well founded in experience that Mr. Warburg is wholly justified in his conclusion that the people must develop a jealous regard for their banking machinery if they wish it to endure. Mr. Warburg, in his article, is apparently less concerned with the past than with the future. Recent experiences indicate the correctness of his views and the basis for his fear of political encroachment. He worked so faithfully and effectively to gain and hold for the Reserve Banks what they have that anything he says has particular and peculiar significance.

Once the Reserve Board was in action, there was the usual clamor for jobs from eager politicians but it was mostly clamor. The positions to be filled were hedged about by qualifications that could not be met by those without banking experience. The position of Reserve agent attracted the avid attention of the politically faithful. The duties of this position were not clearly defined. At first sight it seemed to offer attractions of ease and afford a quiet resting place for an agreeable ex-something classed in political slang as a "lame-duck." There were, of course, hundreds of applications for these places and every applicant was supported by heavy political indorsements.

However, the Reserve Board itself was wisely chosen. Efforts to diversify its membership both in equipment and representative character were successful. The Board, charged with the duty of organizing a new banking system at the time the world was beginning the greatest of wars, did not view the task lightly or politically. Bankers were drafted into the service of the Reserve Banks and accepted, often at large sacrifice. Bankers and business men chosen to the directorates of the Reserve Banks were as much in earnest as the Reserve Board. The political pressure was strong enough to bring a lapse here and there, but the general character and business complexion of the official staffs stood up under close inspection. This early proceeding is to be judged only in the light of results obtained and not by the efforts that were made to impose upon Board or Banks the wishes of those who were politically moved. It is a fair inference that, so far as jobs were concerned, political officialdom passed recommendations along in the serene confidence that the banking minds would accept the responsibility of the refusal to concur.

In any event the Banks came into existence as banks and were opened on November 16, 1914. Having buildings, equipment, officers and staffs, they were naturally curious as to what they might do. Could they advertise and go out after business? No provision had been made for such a course. They would get business when their member banks were hard pressed for funds. Humiliation attached to rediscounting. It was regarded as a sign of weakness. Moreover, while the Reserve Banks were open for business, reserve funds were to be turned over to them in installments. The banking system was otherwise running along as before.

There was, however, much to do. In nearly every district leading banks rediscounted paper for the sake of example.[5] The Reserve Board had to study the law, which settled all difficult problems by saying "under such regulations as the Board may prescribe." It must also be remembered that Aldrich-Vreeland emergency currency was in circulation and was to be retired or supplanted by Federal Reserve notes.

Rules were to be made, precedents set and the gathering of traditions begun. Eligible paper had to be defined; at least, a beginning had to be made.[6] Not only banking customs but business habits would have to be remolded and remodelled, if the Reserve Banks were to have anything on which to function. Acceptances were authorized by the Act. They were new to the banking world. The lessons of war were beginning to say that gold would have to be gathered and impounded.[7] The state chartered banks were hostile or, at best, only neutral. It grew rapidly plainer that they would have to be wooed and won. The law made it mandatory that the clearing and collection of checks and drafts be undertaken. A first step in this direction threw the country banks that were members of the System into spasms of anger and fear. It made the state banks glad that they were beyond such meddling.

The Gold Settlement Fund came as an ingenious means to economy and convenience for member banks. It was a first notable step in what the Reserve Banks could do—something that would be helpful, speedy and cheap. The plan was worked out by the Reserve Board

[5] "Early Functioning of the Federal Reserve System."

[6] "Eligibility for Discount" by Charles L. Powell.

[7] *See* "Preparation for War and the Liberty Loans" by J. H. Case.

in conjunction with experts called from member banks. It was simple and easy and established itself so quickly in favor that it was almost as quickly forgotten as a service. It has always worked perfectly and stands now as a real achievement.[8] It is a service no less to business than to banks.

The story of the winning of the state banks and of par collections is told in the paper by Mr. Pierre Jay, Chairman of the Board of the Federal Reserve Bank of New York. Mr. Jay was called to that position from the presidency of a state bank. It is needless to say that his sympathetic understanding of state bank problems, his patience and persistence found opportunity for display in dealing with those institutions. But the national banks within the System were more rebellious than the state banks without it. They would not be mollified and they were impervious to argument. They nearly disrupted the American Bankers Association. They forced Congress to consider amendment of the Act and missed winning completely by a narrow margin. They went to law about it. It is possible still to make exchange charges and they are made, but the "par collection" competition is too strong. In the face of all the obstacles the Reserve Banks are now the great instruments for check collections and they will have competition in this field only from banks of great reach, capable of maintaining the necessary connections and facilities.

However, the War, not the wooing, brought the state banks into the System—not all of them, of course, but a number in point of resources quite great enough to give the Reserve System the necessary universality—if there is any such thing as a degree.

[8] "The Evolution of the Gold Settlement Fund" by George J. Seay.

The development of the relations of Reserve Banks to their members and with one another immediately became a serious problem once the Reserve Banks were in operation. How this was done and what was and is being done, is told by Mr. Gidney. The Reserve Banks can never supplant "correspondent" banks. There are too many services the latter render, too many personal and long-standing connections, but the Reserve Banks have made great progress and have brought their depositors to a realization that they are customers and will be treated as such. The development of close relationships among the Reserve Banks and their officials has also been as important as it is interesting. Unity demanded it, but systematic effort was essential to its achievement.

There will always be non-member banks because banking is often specialized and men have notions of independence. The mutual savings banks of the East are not eligible to membership. They have no capital stock. The laws have been changed in one or two states to permit them to invest a part of their funds in "commercial paper" and acceptances, but their investments are not supposed to be liquid, and they are far removed from commercial banking.

Probably there will always be private bankers with freedom to operate within that borderland where investment and commercial banking meet and divide, or on both sides of it. But the Reserve System, as now formed of Reserve Banks, national banks, state banks and foreign trade banks, is sufficiently inclusive and strong to permit the statement that it is as nearly universal as necessary. There is nothing on the horizon, or nearer, to indicate that it will diminish instead of grow.

Amendments to the Reserve Act have been fairly numerous, but generally they have been made to meet conditions that could not be foreseen or to make operating conditions easier or simpler. It is good fortune as well as good judgment that there has yet been no success in perverting the provisions of the Act. Congress has so far yielded to the guidance of the Reserve Board and, when there was threat of unsound doctrine, Carter Glass, as representative and senator, has been found on guard. The first thrust at the integrity of the System by the War Finance Corporation has been parried. Even the admission that that Corporation is now doing commendable work and meeting an urgent need, does not justify dismissal of the hope that its life and the emergency which revived it, will both end as scheduled on July 1, 1922.

Amendments to the Act are discussed in Mr. Walter S. Logan's paper where their bearing and trend may be learned. In this connection it is not amiss to say that bankers have contributed loyally to the effectiveness of the Reserve Banks' operations. If they fought lustily, through one or two groups, against par collections, they coöperated zealously by surrendering their gold to the Reserve Banks. Without the War the impounding of gold would have been exceedingly difficult; as it was, it required effort. But good teaching and good leadership carried through, in the closing months of 1917, a plan whose success stood as a milestone in the progress of the Reserve System.

Branches of the Federal Reserve Banks were established and opened in the interest of service to business. The jealousies engendered by the selection of Reserve Bank cities and the making of reserve districts were wiped out in this way, but the branch banks have proved the necessity for their existence. Governor Fancher, of the Cleveland Reserve Bank tells the story.[9] There are, however, variations in the operation of branches. In the far West the geographical extent of the San Francisco district demanded a larger independence in management for the branches than in the East, but telegraphic communication is always close.

The assumption of the functions of the Independent Treasury—see Professor Wildman's article—came belatedly. It was probably as well that it was deferred by politics and war. When it did come, the banks were experienced and ready. So far as the public was aware the subtreasuries slipped their moorings and drifted into the sea of oblivion with no one's knowing or caring.

EXPANSION, CONTRACTION AND THE DISCOUNT RATE—VITAL PROBLEMS

It was thought advisable by the editors of this volume to have as wide a discussion as possible of "Expansion and Contraction." Involved with this question is the influence of the rediscount rate on business activity and, therefore, the relation of the rediscount rate to business and to the expansion and contraction of money and credit.

The Reserve Board is charged with many duties. The Reserve Banks function in many ways. But no question goes more to the vitals of the entire scheme than the adjustment of the discount rate of the Reserve Banks. Whatever else they may do and however successful they may be in the discharge of collateral and subsidiary duties, around the discount rate and its making cluster the factors that bear

[9] "The Establishment and Scope of Branches of Federal Reserve Banks."

directly on the success or failure of the Reserve Banks as aids to commercial business or to the member banks which act in response to business and react to its advantage.

The relation of the Reserve Banks' discount rate to and influence on business has by no means been determined. The factors to be considered in determining the rate are pretty well settled, but their relation to one another and the relative importance of each is still an open question. In seven years of operation the determining of the discount rate has been influenced by extraneous or distracting conditions. At first when the Banks were new, it was of no importance. When war pressed, other factors received scant attention. After the Armistice the belief that the unexampled prosperity would endure, supported the Treasury's needs for more financing. When, finally, something had to be done to avert a crash, it was found that no genuine experience in adjusting the discount rate to influence business had been had. The first increase of the rate to "slow up" business came as an arbitrary decree based on a conception drawn from British experience. That was in January, 1920. Business did not slow up. It went on, undoubtedly despite the higher rate, despite the warning, but, because of what? Possibly because of its own momentum. Expansion increased. It was many gloomy months after the rate was first increased before the peak of either credit or currency expansion was reached. In the meantime business generally declined to believe that the end of war prosperity had come or that the revival and continuation of it was not around the corner. The Reserve Board and the rates of the Reserve Banks were mentioned only to be damned. All kinds of allegations, charges, proposals and remedies were made. In the end the rate was popularly charged with undoing business—for lack of a better reason.

All this was a new experience with the discount rate. It was a valuable experience because it was a first lesson in the time relationship between business activity and the Reserve Bank's discount rate which, to whatever extent it affects business activity, can do it only through the influence it exerts on the rates charged by member banks.

In the articles on these questions, a wide range of experience, supplemented by opinion and study, was sought. Bankers, Reserve Bank officials, merchants, economists were all invited to express themselves. Governor Harding, of the Reserve Board, has stated the problem as it is before the Board. Mr. John H. Rich, Chairman of the Board of the Minneapolis Reserve Bank, has furthered the discussion with views and experiences in that extensive and interesting Reserve district. Dr. A. C. Miller of the Reserve Board, has brought to bear on it a mind singularly free from prejudice and admirably equipped to ferret out and interpret facts. Mr. John V. Farwell, from the merchant's interested and detached position, gives helpful suggestions and clear exposition. Mr. J. B. Forgan, dean of bankers, and tried in experience by long service on the Federal Advisory Council, and Mr. George M. Reynolds, from a terraced height of banking leadership fairly won, make contributions which are supplemented by those of Professor E. M. Patterson of the University of Pennsylvania and Dean Chester A. Phillips, of the University of Iowa, theorists in the field of economics but with practical bents and adept in the use of scientific method.

Needless to say, these men are not entirely in agreement. But close reading of their contributions will disclose

that they are far from hopelessly apart. Any divergence of statement is not over what the discount policy has been, but rather in emphasis as to what it should be in the future.

The problem of the time relationship between the rediscount rate and business activity seems vital in the discussion. Of the efficacy of the rediscount rate to influence business there is little room for question. Recent experience, however, indicates a considerable lapse between the time of fixing the rate and the time when business feels and responds to it. On January 21, 1920, the first increase in discount rate to six per cent was made. This rate was maintained until the following June when the rate for Chicago and New York was increased to seven per cent. This rate was maintained for a year. In June, 1921, the lowering began.

The point made by Mr. Reynolds is that business is not immediately affected by the rates charged by commercial banks. The rediscount rate can affect business activity only through its effect on the rates of commercial banks. But banking, as a result rather than a cause of business activity, can react only after business has made commitments which it is bound to carry through if it can. If, under the present relationship between the rediscount rate and business activity, the rate is to be adjusted effectively, adjustment must be made in anticipation of a business activity which may need restraint or of an inactivity which may need stimulation. Such an adjustment might be precarious and it would likely be uncertain. It is venturesome to say that the rates charged for loans by member banks would be a better guide in seeking a basis for the rediscount rate, for those rates have variations, as do the rates charged for standard "commercial paper."

The condition outlined shows the strength of the position of those who say the rediscount rate should always be higher than, say, the rate for standard commercial paper charged by member banks. However, there are strong arguments why the rediscount rate should sometimes be lower. At present the lower rate is giving many hard pressed banks in the farming sections a needed breathing spell. A lower rate's influence in stimulating business may also be problematical unless the member banks adjust their rates to it as quickly as possible and with considerable speed in any event.

It is not that these statements create a dilemma but they seem to justify no other conclusion than that further experience in influencing the rates of member banks, if not further experiment, is necessary before it may be said that wisdom is justified of her children.

IMPORTANCE OF THE "OPEN MARKET"

If operation of the Federal Reserve Banks, under stable conditions of business, is to be seasonal and cyclical, as many of the contributors to this volume seem to believe, the further development of open-market operations will be in order. It so happens that the Reserve Banks, early in their careers, found war a wonderful accelerator. War made them busy and prosperous. Henceforth they will operate under changed conditions. Not that there will not be continuous business for the Reserve Banks, but they will not be carrying peak loads twelve months in the year. Their operations in the open market will be more important under the new conditions than in the past. In this field they may find it possible to exert an influence which will make for the stabilization of money rates.

Mr. Agger tells of the development and position of the open market. From what has been achieved we may get an idea that here is a field for cultivation, with success reacting to demonstrate another and large service the Reserve Banks may render business. The law made provision for such conduct by the Reserve Banks and its importance must be kept in mind.

MISCONCEPTIONS OF THE SYSTEM

Under the stress of financial difficulties incident to war and its aftermath the Reserve Banks came in for a full measure of criticism. It was to be expected, and it is not surprising, that a portion of the criticism was hostile as well as adverse. Professor Patterson, in his discussion of contraction and expansion, gives a very clear elucidation of Reserve Bank operations in their relation to government financing, foreign business and conditions and commercial banking. In these operations will be found such basis as exists for real criticism. The article might well be read with that also in mind.

In his review of the "Popular and Unpopular Activities of the Federal Reserve Board and the Federal Reserve Banks," Dr. Scott goes more particularly into these criticisms, the reasons for them and the shallowness of most of them, while Governor McDougal of the Reserve Bank of Chicago, gives a striking illustration of the lean foundation on which rest the allegations of discrimination against the agricultural districts.

It is not enough to state what the Federal Reserve System is designed to do, if the fundaments of that System are to be understood. Current misconceptions must be cleared away. The prevalence of erroneous ideas compels such procedure.

A wide-spread notion prevails, even among bankers, that the Federal Reserve Banks are government banks. They are bankers' banks. This fact is written into the Federal Reserve Act.[10]

It is implied in the provisions of that instrument.[11] It is not only recognized by economists,[12] but also indorsed by operating officers of Reserve Banks.[13] No Federal Reserve Bank stock is held by the Federal government. The government possesses its regulatory power because the System is freighted with a public interest. The government has an interest in Reserve Bank profits only through a franchise tax. The Federal Reserve Banks are subject to taxation like other private corporations. To be sure, a minority of the directors of Reserve Banks are appointed by the Federal Reserve Board and members of that Board are government appointees exercising supervisory powers in the public interest. Moreover, Federal Reserve Banks do act as fiscal agents, and in other ways, for the government's convenience. Nevertheless, Federal Reserve Banks are not government banks. They are bankers' banks designed to aid business by facilitating commercial transactions. The fact that the Reserve Banks are not government banks destroys the ground work for assumptions: (1) That the System can produce general "prosperity," and (2) that it should be dominated by government.

Under the stimulation of war the facilities of the Reserve Act for expansion became an engine of inflation. They cannot be made an engine of "pros-

[10] *See* the Act and Professor Kemmerer's paper in this volume.

[11] Cf. "The Reserve Act in its Implicit Meaning."

[12] *See* Professor Phillips' article, for example.

[13] Cf. "Relations of Reserve Banks to Member Banks and Inter-Relations of Federal Reserve Banks."

perity." Neither deft nor awkward political manipulation can turn the Reserve System from its strictly economic purpose. It was not designed to salvage insolvents. It cannot create credit out of nothing. While commercial banks can control the flow of commercial credit and thus affect the currents of the productive processes, business creates that credit which banks, even the Reserve Banks, apportion. Business impels; banking controls the drives,—after a time. If there *must* be a causal relationship between business and banking, business causes banking. There is actually a functional relationship. Business gives rise to banking and banking reacts on business. Neither commercial banks nor Reserve Banks can create credit and thus create "prosperity."

One of the facts that doubtless has obscured thinking about the fundamental play of commercial banking is this one, that the Reserve Banks have handled government issues, rediscounted paper secured by government obligations and otherwise performed war functions for the Federal government. They have been functioning, in no small measure, on *other* than commercial credits. This was not their original purpose. Government promises to pay should not be the chief grist taken to the Reserve Bank mill. But as a result of war operations, the assumption that Reserve Banks can "manufacture" credit out of nothing seems to find justification with those who have not seen the underlying sources of the promises to pay on which the Reserve Banks have been functioning. Business, not banking, creates what is called "prosperity."

An instance of government domination of the Federal Reserve System can be found in the control of the rediscount rates by the rate on government bonds.[14] This control was no doubt bred of war's necessities. The War is over. But no end has come to political pressure on the Reserve System. That pressure seems now to come through Congress, or a section thereof, rather than through the Administration. It is suggestive, if not legally accurate, to say that the Federal Reserve Board can exercise those powers expressly granted or necessarily and fairly resulting therefrom, while the Reserve Banks hold residual powers. "Less government in business" can find a starting point in the Reserve System. Government supervision is very different from political manipulation. These bankers' banks should be unhampered by politics.

A current misconception that is giving way is the notion of dead-level uniformity of policy and practice among the Reserve Banks. The Federal Reserve System meets the necessities of American geography and history in providing regional banks with a centralized supervision. This fact is attested by many of the contributors to this volume.[15] Presumably each Reserve Bank will adapt its policy and practice to the hard and particular facts of the business situation in its district.[16] Where differences in procedure are necessary, they must and will be allowed by the Federal Reserve Board, just as differentials in discount rates are "permitted" between districts that are dissimilar. The Reserve Board will play its part of leadership by functioning on *common* matters of policy and practice without constraining the directors of the various banks in matters of

[14] *See* Governor Harding's statement in the article, "Rediscount Rates, Bank Rates and Business Activity."

[15] *See*, for instance, the articles by B. H. Beckhart and John H. Rich.

[16] *See* the paper by H. Parker Willis in this volume.

justifiable difference. Thus will the System best perform its service in facilitating commerce. Arbitrary control, political interference and dead-level uniformity will destroy, not maintain, the integrity of the Federal Reserve System.

THE AVOIDANCE OF INVESTMENT OPERATIONS BY RESERVE BANKS

Investment banking should have no place in the operations of Federal Reserve Banks. Their reason for being is to aid commercial banking. Investment operations can be avoided by confining the paper eligible for discount at the Reserve Banks to commercial paper.[17]

Should the Federal Reserve Banks perform such agricultural credit functions as are now being developed by the War Finance Corporation and should they be "adapted" to such functions? The answer to this question will not only emphasize the distinction between commercial and investment banking—in what may be urged as a border-line case—but will also illustrate the need of confining eligible paper to that which evidences a movement of goods from producer to consumer and is self-liquidating.

The original purpose of the War Finance Corporation is of no present moment. The essential purpose of Section 24 of the War Finance Corporation Act, under which the Corporation is now operating, is to give bankers and farmers time in which to pay their obligations. Banks in various agricultural communities have made loans for "agricultural purposes" which cannot be repaid at maturity out of the proceeds of this year's crop. Some of these banks are themselves having difficulty in meeting their bills payable. This situation is too well known to need elaboration. The War Finance Corporation Act expressly permits banks with "frozen" agricultural credits to apply for advances from the Corporation for six months or a year, with a renewal privilege which may give the obligation a total life of three years. By getting time in which to retire its bills payable, the bank is in a position to give farmer borrowers time in which to make a new crop, or two if necessary, and thus clean up their obligations. The Bank's obligation must be secured by collateral which will insure ultimate payment, but time is given for payment. In short, the Corporation is functioning in the way of carrying the burden of agricultural loans that are slow but should ultimately be paid.

To the extent that the Corporation gets funds into the agricultural sections where frozen agricultural credits still prevail, the operations of the Corporation will no doubt be helpful to banks in those districts and indirectly to the farmer borrowers and the country in general. Whether Section 24 of the War Finance Corporation Act is a sound politico-economic measure need not now be debated. It is a fact. Bankers and economists have few illusions as to the probable extent or nature of its operations, but about one point there can be no doubt, namely, that this giving of time to bankers and indirectly to farmers puts the operations of the Corporation in the class of investment rather than commercial banking. If the Federal Reserve Banks were to carry loans for three years, they would be doing an investment banking business. It is the purpose of the Federal Reserve Act to deal in self-liquidating paper. The Reserve Act might conceivably be amended to

[17] The term *commercial paper*, unless in quotes in this article, means commercial paper as defined in the Federal Reserve Act and rulings of the Federal Reserve Board, and expressly includes agricultural paper. In the case of agricultural paper, however, the maturity of the paper is the essential point in giving it eligibility.

permit the Reserve Banks to perform such long time banking operations as are now entrusted to the War Finance Corporation, but such amendment would be a blow to the integrity of the Federal Reserve System as a commercial banking mechanism.

Should the War Finance Corporation so extend its operations in granting agricultural credits that its capital is exhausted, the Corporation may issue debentures to secure additional funds. The Corporation is empowered by the Act to have advances to banks outstanding at any one time to the amount of a billion dollars. The capital stock of the Corporation, which is owned by the Federal government, is five hundred million dollars. Should the Corporation issue its debentures, these promises to pay must be considered investment paper. They may be used to secure rediscounts with the Federal Reserve Banks. Should they be so used, they will be in the same position as government obligations which are used to secure rediscounts. The propriety of making loans and issuing Federal Reserve notes on the basis of paper "collateraled" by investment securities is a question that may well be raised in considering the integrity of the Reserve System as a commercial banking institution.

Government bonds and debentures of the War Finance Corporation are promises to pay. They are not in themselves evidences of a movement of goods from producer to consumer. They are not self-liquidating as is commercial paper. The legal permission to secure rediscounts with investment paper is a deviation from the original purpose of the Federal Reserve Act. It is true that the Reserve Act makes express provision for rediscounts secured by government obligations.[18] But it is also true that had the framers of the Federal Reserve Act anticipated the World War, the proviso clause in Section 13 of the Reserve Act, which permits rediscounts to be secured by government obligations, would probably not have been passed.[19] And certainly there was sufficient experience with this proviso clause of Section 13, as to its potency for inflation, to have warned against the amendment of the Reserve Act so as to permit the War Finance Corporation's debentures to be used to secure rediscounts. Section 24 of the War Finance Corporation Act was not approved until August 24, 1921.

While government obligations are so extensively held by individuals and business concerns, it is perhaps impracticable to amend Section 13 of the Federal Reserve Act so as to prevent the use of government obligations to secure rediscounts and the issuance of Federal Reserve notes on the security of those obligations. Until the war bonds of the government find a final resting place with investors—which may mean until refunding plans are put into operation—it would probably be impracticable to prevent a member bank's offering the note of a business man for rediscount which is secured by government bonds. Until that time it may be impossible to have Federal Reserve notes issued only in response to commercial needs, evidenced by the offering of commercial paper for rediscount. In the perfecting of the Reserve Act, Section 13 might well be changed, on the chance of a recurrence of very large government demands. There will be no valid excuse for permitting the rediscounting of notes secured by the debentures of the War Finance Corporation should that Corporation function extensively enough to issue its debentures. Of course, it might be

[18] See Section 13 of the Federal Reserve Act.

[19] See paper entitled, "The Reserve Act in its Implicit Meaning."

difficult to sell such debentures without this feature.

The avoidance of investment operations by Reserve Banks will be difficult so long as Congress, or any group of congressmen, can force amendment of the Federal Reserve Act to take from the Federal Reserve Board its power to define eligible paper under the Act as it now stands. In the spirit of the Act the resources of the Reserve Banks are not to be used for withholding crops from the market to secure higher prices. Commercial paper involves the moving of goods to the market, not withholding therefrom in order to insert a price peg or even to secure "more orderly marketing." Measures to admit irrigation and development bonds as paper for the Reserve Banks to function on might conceivably be passed by Congress. But no matter how great the need of particular agricultural districts, or how desirable various measures of relief, it seems clear that the definition of eligible paper should be restricted to commercial paper unless there is a general and well considered intent to depart from the commercial character of the Federal Reserve System.

There may or may not be need of specialized banking machinery to take care of the long time financial requirements of farmers, due to recurrent crop failures or price slumps, as well as their need for long time funds in bringing cattle to market. But in any event that need would have to be determined on the basis of experience that is more than transitory or that arises from a world-wide emergency, caused by the distortions of war. But the fact that these needs exist is not a sufficient reason to destroy the integrity of the commercial banking system that has been established. They rather point the way to the provision of other facilities, if necessary. To destroy the line between commercial and long-time banking, that was not easily established, is to permit just such a situation as now obtains in many country banks. They have slow assets with which to meet quick liabilities. It is as impossible to add investment banking to commercial banking and get security as it is to add apples to oranges and get peaches. And it must not be forgot that the slow obligations of farmer borrowers and agricultural banks can be traced in part to land speculation and inflated land values.

Relation of the Reserve System to International Finance

The Federal Reserve Act permitted the extension of banking operations into the foreign field. Under this authorization American banks branched out in foreign territory extensively and not always profitably. However costly the experience with foreign banking, it is probably safe to say that banks managed by those who are experienced in foreign trade and foreign banking will in the future find sufficient latitude for profitable operation under the Reserve Act.

The Federal Reserve Act was amended by the Edge law to permit an extension of foreign banking facilities through the establishment of new foreign banking corporations in which commercial banks were expressly permitted to own stock. This fact that commercial banks could hold the stock of Edge law corporations is sufficient reason for the Reserve Board's being given supervisory control. Moreover, Edge law corporations were designed to finance imports and exports, but especially to aid the movement of goods from American producers to foreign consumers. They were designed to do a foreign commercial banking business. The Edge law merely extended the provisions of the Reserve Act that had

previously permitted foreign banking. Since the banking business of Edge law corporations is largely commercial in character, the Edge law is not an attempt to graft onto the Federal Reserve System investment features that would have destroyed its integrity as a commercial banking system.

Whether Edge law corporations were or are desirable from the standpoint of practicality is really beside the point. The Reserve Act was extended by the Edge law to put the Federal Reserve System into more intimate touch with international finance. It is merely a matter of record that "rest in peace," in proper Latin phraseology, has been written over the mammoth corporation proposed to be operated under the Edge law.

Dreamer's dreams of international banks, which would restore mint pars of exchange and otherwise work out the difficulties of international finance, can be dismissed with scant consideration. They do, however, contain a warning. The capital of one such bank was to be composed largely of the promises to pay of "solvent foreign governments." The test of solvency was prompt payment of external obligations and the taking of steps towards disarmament. Foreign bonds, even of such "solvent governments," are scarcely to be considered banking capital. It is difficult, also, to see how the operations of such a bank would rectify foreign exchange when any adjustment depends so largely on measures taken by European nations themselves—such as deflation of their currencies and balancing of their budgets—to bring the purchasing power of their moneys more nearly into alignment with the purchasing power of American money. Exchange rates today are on a purchasing power parity. However fatuous such projects, they are conceived by those holding responsible legislative positions and it is not improbable that somehow, if a law were passed to establish such an international bank, that bank would get itself tied up with the Federal Reserve System. It is against such projects that the Federal Reserve System must be safeguarded by an alert and vigilant public opinion which allows no deviation from its commercial character.

Though the condition of business in the United States is affected by the play of world-wide economic and political forces and the Federal Reserve System is affected by the condition of business, that System touches the international financial structure immediately at one point, through its control of gold. How the Federal Reserve Board impounded gold is told in Mr. Case's article. The Reserve Board's control of the gold of the United States is now complete. Certain it is, also, that the flow of gold into the United States shortly after the outbreak of the War, but particularly since September, 1920, has resulted in such redistribution of the world's stock of monetary gold as to give the United States—the Federal Reserve Board—control of some 40 per cent of that stock.

In this connection the article of Dr. Sprague may be read with profit. There is within the Reserve System, as operated, an inherent power for expansion. The manner in which gold is handled is of the greatest importance and Dr. Sprague has indicated the dangers to be guarded against in the future as well as those which have not been met effectively in the past.

PURPOSE OF THE VOLUME

The purpose of this volume is naturally to be ascertained from the reading of the various articles contributed. Books have been written on the Reserve System. Some of them have given its

purposes and some have been devoted to its operations and operating mechanism. The editors assumed, however, that heretofore no opportunity has been offered to bring together in one volume the authoritative statements from those who were directly interested in framing and formulating the Act and were, therefore, familiar with its purposes; from those who were and are actively connected with the operation of the Reserve Banks and therefore competent to interpret their conduct, and from those who directly and indirectly make use of the Banks or are keenly interested to study the progress of the System.

Thus we have in this volume of *The Annals* the Reserve System as contemplated by its framers, as operated by those in charge, and as observed by those in a position to interpret the operations in relation to the purpose. In any event these three forces were sought and have responded. The relationship between purpose and operation is set forth and the limitations as well as the scope of the System have been shown.

It is pertinent to add that sight was never lost of the fact that the Federal Reserve System is not generally understood. It is unfortunate that it is distinctly misunderstood. If this volume is of any assistance in clearing up the misunderstandings and giving a better conception of the work and the mission of the Reserve Banks, the editors will feel fully rewarded. They owe everything to the contributors who have responded so capably and generously to their requests, often, it may be said, despite of engagements and the pressing demands of their own businesses. No editors were ever more fortunate in securing coöperation from contributors.

It is only an editorial hope that the volume may meet approval. It was fairly intended to produce a useful and practical work. Whether it does or does not perform a useful service, we feel justified in appending the message for the book suggested by the governor of a Reserve Bank: "It will not be easy reading; it may not be agreeable reading, but I think it mighty important that every business man should read it."